

ENEMY AT THE GATES: HOW CAN INVESTORS STOP HEDGE-FUND MANAGERS FROM UNNECESSARILY SUSPENDING REDEMPTIONS?

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I. INTRODUCTION

Randy Lerner, the billionaire owner of the Cleveland Browns football franchise and the Aston Villa soccer club,¹ is no stranger to hard times in the sporting arena.² But in 2010, he also suffered a setback with his investment portfolio when trying to redeem a \$40,000,000 investment from the hedge fund, Paige Capital Management, LLC (Paige Capital).³ The fund's managers, Michele and Christopher Paige, apparently parked most of Mr. Lerner's investment in cash for two years, refused to fully disclose where the money was invested and collected management and incentive fees on the assets.⁴ When Mr. Lerner notified Christopher Paige of his desire to redeem his assets, Mr. Paige responded with a particularly nasty letter threatening litigation and restriction of Mr. Lerner's withdrawal.⁵

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¹ *Randolph Lerner*, FORBES (Mar. 2011), <http://www.forbes.com/profile/randolph-lerner>. Randy Lerner is the 393rd richest American, having inherited his fortune (including ownership of the Cleveland Browns) from his father, Al Lerner.

² Brian Solomon, *The Best and Worst NFL Owners*, FORBES (Nov. 2, 2011), <http://www.forbes.com/sites/briansolomon/2011/11/02/the-best-and-worst-nfl-owners.html>. Randy Lerner was named fourth worst NFL owner, based on his team's poor performance on the field and lack of financial growth.

³ Jef Feeley, *Cleveland Browns' Lerner to Get Fund Investment Back, Delaware Judge Rules*, BLOOMBERG (Aug. 9, 2011), <http://www.bloomberg.com/news/2011-08-08/browns-lerner-to-get-investment-in-hedge-fund-back-judge-rules.html>.

⁴ *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. CIV.A.5502-CS, 2011 WL 3505355, at *6, *8, *13 (Del. Ch. Aug. 8, 2011). Mr. Paige's letter contained the following language:

[W]e are fully prepared to litigate this matter to the bitter end because we will continue to manage your money, and collect management and incentive fees, until this matter is resolved many years hence. The economic reality, therefore, is that you cannot win because you will spend more litigating than we're fighting over.

Id. at *13. The analysis of the Delaware Chancery Court's opinion will be discussed later in this note. See discussion *infra* Part V.A.

⁵ *Id.* at *13.

This letter, which Mr. Paige fiercely sought to keep out of evidence at trial,⁶ embodies the worst intentions a hedge-fund manager could have when deciding to restrict or suspend an investor's redemption rights.⁷ Despite their Ivy League legal training, the Paiges did not turn out to be great hedge-fund managers, as Michele Paige's only investment decision while managing Paige Capital (and other related entities) was to forestall investment because she thought she could acquire assets at a lower price if she waited.⁸ This story highlights one of the possible perils that hedge-fund investors face when handing over large sums of money to managers who may not be equipped to manage it.

Hedge funds are investment vehicles that often use risky investment strategies.⁹ These strategies allow funds to achieve positive returns regardless of market conditions.¹⁰ Hedge funds have also been called "absolute return funds" because their claims of generating positive returns under all market conditions. However, the recent economic downturn made it clear that hedge funds can no longer label themselves as such.¹¹ Nevertheless, despite their recent losses, hedge funds have continued to outperform the overall market,¹² and research over the past two decades bears this out.¹³ To avoid more stringent regulation, these funds restrict participation to individuals with a high net worth, usually with minimum investments of \$5,000,000,¹⁴ and often use derivative instruments or engage in short selling to limit their market exposure.¹⁵ These funds have historically enjoyed little regulatory oversight, and they have not been required to register with the Securities and Exchange Commission (SEC);¹⁶

⁶ *Id.*

⁷ Interestingly, Mr. Paige was running for the Republican nomination for a U.S. House of Representatives seat in northeastern Pennsylvania, and his decision to drop out of the race coincided with his letter to Mr. Lerner. Feeley, *supra* note 3.

⁸ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *3, *12.

⁹ Jane J. Kim, *Concerns Grow About Prospects of Hedge Funds: Wall Street Strategists Warn That Results May Languish; Past Returns Also Questioned*, WALL ST. J. (Dec. 15, 2004), <http://online.wsj.com/article/SB110306065772900022.html>.

¹⁰ *Id.*

¹¹ Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 245 (2009).

¹² *Id.*

¹³ *Hennessee Hedge Fund Index in the Worst 15 Months of S&P Decline (1993–2010)*, HENNESSEE GROUP LLC, <http://www.hennesseegroup.com/indices/returns/downmarketanalysis.html> (last visited Mar. 27, 2012). The graph from Hennessee represents the "absolute-return" nature of hedge funds, detailing the limited losses (and even gains) in comparison to the market's steepest declines over the past two decades.

¹⁴ DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUND INVESTORS, 75 (2005).

¹⁵ Kim, *supra* note 9.

¹⁶ Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPREN. BUS. L.J., 1, 3 (2006).

however, recent legislation will soon implement increased regulation while requiring larger fund managers to register.¹⁷ The funds' managers typically charge management fees of 1 to 2% and performance fees of 20%.¹⁸

During the financial crisis of 2008, the hedge-fund industry was flooded with investor redemption requests, which consequently led fund managers to impose redemption "gates" that were designed to limit redemptions that exceeded a certain percentage of a fund's assets.¹⁹ Prior to 2008, redemption gates were not used regularly²⁰ and often their use signaled the effective end of a hedge fund.²¹ When a fund manager suspended redemptions, it was like a self-fulfilling prophecy that the fund would be unable to continue operation and pay out the requested redemptions.²² Because the use of redemption gates exploded in 2008,²³ it is important to examine the legality and enforceability of these "gate" provisions in the context of the contracts and investment agreements that allow their use. Even though funds have better matched their liquidity profile with their redemption profile in the past few years,²⁴ hedge funds could see another round of sizable redemption requests after lackluster performance in 2011.²⁵

This note will address the recent use and abuse of redemption gates in hedge funds, and explore solutions for their continued use when appropriately imposed. First, it will discuss how hedge funds are structured,

¹⁷ Andrew Ackerman, *Global Finance: Rules for Hedge Funds Get Pruned—SEC Backs Requirement for Periodic Reports, but Only Largest Firms Must File on Quarterly Basis*, WALL ST. J., Oct. 27, 2011, at C3.

¹⁸ Kim, *supra* note 9.

¹⁹ Joseph Checkler, *Selling Hedge-Fund Stakes*, WALL ST. J., Oct. 23, 2008, at D5.

²⁰ George Zuckerman, *Hedge-Fund Investor Goal: An Exit Plan*, WALL ST. J., Sept. 9, 2009, at C1 [hereinafter *Exit Plan*].

²¹ Symposium, *A Fistful of Dollars: Hedge Funds, Private Equity and Bankruptcy, A Symposium: Into the Sunset: Bankruptcy as Scriptwriter of the Denouement of Financial Distress*, 7 DEPAUL BUS. & COMM. L.J. 597 (2008–2009) [hereinafter *Fistful of Dollars*].

²² *Id.*

²³ George Zuckerman, *Hedge-Fund Gate Bashing Yields Little*, WALL ST. J., June 24, 2009, at C14 [hereinafter *Bashing Yields Little*] (stating that more than 15% of all hedge funds imposed restrictions on investor redemptions during the market crisis in 2008).

²⁴ Amy Or, *Hedge Funds' 3Q Is Fourth Worst Quarterly Performance*, DOW JONES NEWSWIRES (Oct. 7, 2011, 4:15PM), <http://www.djnewsplus.com/rssarticle/SB131801826083291203.html>.

²⁵ Steve Eder, *Hedge Funds Face Investor Pruning*, WALL ST. J., Oct. 24, 2011, at C1; Margot Patrick, *Hedge Funds Face New Round of Redemptions*, WALL ST. J. (Sept. 28, 2011), <http://www.marketwatch.com/story/hedge-funds-face-new-round-of-redemptions-2011-09-28>.

how fund managers are compensated and how managers and investors contract. Second, it will discuss the process by which investors enter and exit hedge-fund partnerships. Third, it will explore the reasons for redemption gates and whether gates are truly necessary. Fourth, it will discuss the recent court ruling in Delaware regarding the legality and enforceability of redemption gates. Lastly, it will offer solutions on how fund investors and fund managers can act more cooperatively to create a balanced approach to maintaining liquidity for exiting investors, while preserving capital for the funds' remaining investors.

II. HOW ARE HEDGE FUNDS STRUCTURED AND WHAT DOCUMENTS ARE CONTROLLING?

This section will explore how hedge funds are structured and the reasons for their structure. First, it will discuss the statutory framework in which hedge funds operate. Second, it will discuss the statutory exemptions that allow the existence of hedge funds. Third, it will examine the organizational and compensation structures that hedge funds employ. Fourth, it will discuss the ongoing controversy over hedge-fund manager compensation. Finally, it will discuss the documents that are used to create hedge-fund partnerships.

A. *The Statutory Basis Allowing the Creation of Hedge Funds*

The statutory basis for hedge funds lies in the funds' regulatory exemptions from parts of the Securities Act of 1933 (1933 Act),²⁶ the Securities Exchange Act of 1934 (1934 Act), the Investment Company Act of 1940 (Company Act)²⁷ and the Investment Advisers Act of 1940 (Advisers Act).²⁸ Although recent legislation changes the way some of these exemptions apply,²⁹ hedge funds have historically been exempt from the public offering registration requirements of the 1933 Act,³⁰ the reporting obligations of the 1934 Act and the registration requirements of the Company Act.³¹ Hedge funds have enjoyed important exemptions stemming from either of two exclusions created in the definition of an investment company in the 1940 Act.³² These funds can avoid being considered investment companies because they do not have more than 100 investors (the fund itself can be considered a manager's only client)³³ or

²⁶ 15 U.S.C. § 77d(2) (2006).

²⁷ *Id.* § 80a-3(c)(7); *id.* § 80a-2(a)(51)(A).

²⁸ *Id.* § 80b-3(b)(3).

²⁹ Ackerman, *supra* note 17.

³⁰ 15 U.S.C. § 77d(2).

³¹ *Id.* § 80a-3(c)(7); *id.* § 80a-2(a)(51)(A).

³² Oesterle, *supra* note 16, at 5.

³³ 15 U.S.C. § 80a-3(c)(7).

because they only allow investors that are “qualified purchasers” (including individuals with over \$5,000,000 in investments).³⁴

Although hedge funds are exempted from the regulations of the Company Act,³⁵ hedge-fund managers may be considered investment advisers as defined in the Advisers Act and thereby fall under its regulation.³⁶ Hedge-fund managers, like all investment advisers under the Advisers Act, are prohibited from making material misstatements, making misleading omissions and committing fraud.³⁷ But—managers can be exempted from the registration requirements under the Advisers Act if they qualify as a private adviser.³⁸ A private adviser must not have advised more than fifteen clients in the previous twelve months (each different fund being a different client), must not hold itself out to the public and must not advise a registered investment company (as defined by the Company Act).³⁹ Hedge funds also gain exemption from the 1933 Act by only making private offerings and by limiting their investors to those with “accredited investor” status.⁴⁰ Accredited investors, under the 1933 Act, are those whose net worth exceeds \$1,000,000 or who have earned \$200,000 or more in each of the last two years.⁴¹

B. The Reasoning for Allowing Hedge-Fund Exemptions

Inherent in these exemptions used by hedge-fund managers is the understanding that hedge funds will not actively advertise to the public and that the funds will limit their investors to those who can sustain the increased investment risk. The U.S. Supreme Court ruled that an offering to investors who are able to fend for themselves (e.g. sophisticated and informed investors) is not a public offering, and therefore it is an exempt transaction.⁴² Regulatory requirements and the investors’ perceived level of sophistication allow managers to impose liquidity restriction on investors.⁴³ These investors are wealthy enough to be informed of the inherent risks associated with their investment.⁴⁴ Because of the sheer size of the hedge-fund industry, lawmakers have been concerned that lack of regulation could result in real systematic risk for the financial system.⁴⁵ The

³⁴ *Id.* § 80a-2(a)(51)(A).

³⁵ *Id.* § 80b-3(b)(3).

³⁶ Shadab, *supra* note 11, at 255.

³⁷ *Id.* at 256 (discussing 17 C.F.R. § 275.206(4)-8 (2011)).

³⁸ 15 U.S.C. § 80b-3(b)(3).

³⁹ Shadab, *supra* note 11, at 258.

⁴⁰ *Id.* at 258–59.

⁴¹ *Id.* at 259.

⁴² SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953).

⁴³ See Shadab, *supra* note 11, at 259.

⁴⁴ See *id.*

⁴⁵ Bart Mallon, *Wall Street Reform and Consumer Protection Act*, HEDGE FUND L.

numbers tell a different story, however, because in the recent economic downturn, hedge funds lost only around 18% on average, while the market overall lost around 40%.⁴⁶ Regardless of whether the need for regulation is real, Congress enacted legislation increasing regulatory oversight, which will be implemented soon; however, some efforts to delay its implementation and limit its original scope have been successful.⁴⁷

C. *The Business and Compensation Structures that Hedge Funds Employ*

Hedge funds are typically structured as limited partnerships or limited liability companies (LLCs).⁴⁸ Some foreign hedge funds, known as offshore funds, are structured as limited corporations and are domiciled outside the United States, usually in the Cayman Islands or the British Virgin Islands.⁴⁹ In the most common structure, the limited partnership, there are two types of partners: limited partners and a general partner.⁵⁰ The limited partnership structure also allows for favorable tax treatment for the partners, in that the gains and losses of the partnership are passed through and thereby only taxed once at the individual partner level.⁵¹

The general partner is usually the fund's portfolio manager and is in charge of managing all other aspects of the fund's business.⁵² The general partner owes fiduciary duties to the limited partners, and while it controls all of the fund's decision-making, it is only bound by the terms of the partnership agreement.⁵³ The general partner is subject to unlimited liability for any unsatisfied debts of the partnership, but most general partners are organized as LLCs, thus easily limiting the personal liability of the individual controlling the organization.⁵⁴ In contrast to the general partner, a limited partner maintains very little, if any, control of the partnership's decision-making, and thereby limits its own liability stemming from the partnership.⁵⁵ A limited partner's investment alone does not make it

BLOG (June 26, 2008), <http://www.hedgefundlawblog.com/wall-street-reform-and-consumer-protection-act.html>.

⁴⁶ Shadab, *supra* note 11, at 243–44.

⁴⁷ Ackerman, *supra* note 17.

⁴⁸ HAMMER ET AL., *supra* note 14, at 88.

⁴⁹ Bart Mallon, *Offshore Hedge Funds—Structure and Considerations*, HEDGE FUND L. BLOG (Sept. 26, 2008), <http://www.hedgefundlawblog.com/offshore-hedge-funds-structure-and-considerations.html>.

This note will focus mainly on limited partnerships domiciled in the United States, because many offshore funds are simply created as a “shell” for foreign investors.

⁵⁰ HAMMER ET AL., *supra* note 14, at 88–89.

⁵¹ Shadab, *supra* note 11, at 249.

⁵² HAMMER ET AL., *supra* note 14, at 89, 94.

⁵³ DEL. CODE ANN. tit. 6, § 17-1101(c), (d) (2011).

⁵⁴ Shadab, *supra* note 11, at 249 (discussing DEL. CODE ANN. tit. 6, § 17-403).

⁵⁵ DEL. CODE ANN. tit. 6, § 17-303.

responsible for the liabilities of the fund, and the major down side risk facing a limited partner is the loss of its investment.⁵⁶

D. The Controversy Surrounding Hedge-Fund Manager Compensation

Hedge-fund manager compensation is a controversial issue,⁵⁷ especially with many managers earning massive fees in recent years, despite the economic recession.⁵⁸ Fund managers typically charge management fees ranging from 1 to 2% per annum of the fund's assets under management (usually calculated at the beginning of the period, either monthly or quarterly).⁵⁹ The use of management fees as a way to compensate money managers is very common throughout the investment industry, and it is not limited to only hedge-fund managers.⁶⁰ However, investment advisers to investment companies are prohibited from charging performance fees, while hedge-fund managers are not.⁶¹ Hedge-fund managers draw a significant portion of their compensation from the performance fee structures they employ.⁶² Their performance fees (also called incentive fees, carve out or "the carry") typically range from 15 to 20% of the fund's gains.⁶³ These performance fees, usually charged on an annual basis, can be as high as 40% of the fund's gains.⁶⁴

The fund usually has to outperform some predetermined benchmark and/or be above the fund's "high-water mark" before a manager can charge incentive fees.⁶⁵ Because high-water marks are used to limit managers' compensation, it is understandable that managers will try to find creative ways to avoid having their funds "underwater." For example, after the recent economic downturn, some managers whose funds had lost significant value decided to voluntarily close their funds and return investors' capital

⁵⁶ See *id.*

⁵⁷ Zachery Kouwe, *Hedge Funds Challenged Over Fees*, DEALBOOK (Sept. 17, 2009, 12:16 AM), <http://dealbook.nytimes.com/2009/09/17/hedge-funds-challenged-over-fees/>.

⁵⁸ Nelson D. Schwartz & Louise Story, *Hedge Fund Pay Roars Back*, N.Y. TIMES, Apr. 1, 2010, at B1.

⁵⁹ Shadab, *supra* note 11, at 250.

⁶⁰ *Id.* (discussing SEC, *Invest Wisely: An Introduction to Mutual Funds* (Aug. 8, 2007)).

⁶¹ 15 U.S.C. § 80b-5(a)(1) (2006).

⁶² Oesterle, *supra* note 16, at 39 (discussing SEC Staff Report to the SEC: *Implications of the Growth of Hedge Funds*, at 109 (Sept. 2003)).

⁶³ James R. Barth et al., *Hedge Funds: Risks and Returns in Global Capital Markets*, MILKEN INST. 32-34 (Dec. 2006).

⁶⁴ ARTHUR MACEWAN & JOHN A. MILLER, *ECONOMIC COLLAPSE, ECONOMIC CHANGE: GETTING TO THE ROOTS OF THE CRISIS* 101 (2011).

⁶⁵ Joseph Checkler, *Funds Inch Past the High-Water Mark*, WALL ST. J., Oct. 12, 2011, at C1.

rather than stay open and try to recoup their losses.⁶⁶ Managers did this not only because staying open and regaining their losses would be difficult, but also because their compensation for such positive performance of their funds would be far less lucrative in view of investors' high-water marks.⁶⁷ However, many notable hedge funds that remained open had regained their high-water marks by the end of 2009.⁶⁸ Historically, hedge funds as a group have not had difficulty outperforming the benchmarks that are set by market.⁶⁹

The tax treatment of managers' performance fees adds to the controversy over managers' compensation. Briefly, the controversy arises because the performance fees charged by managers enjoy tax treatment at long-term capital gains rates (currently 15%) instead of ordinary-income rates (currently a maximum marginal rate of 35%).⁷⁰ The main argument for this treatment is that the fees are technically the managers' share of the funds' investment returns, which are gains or losses from owning long-term capital assets, therefore such gains should be taxed at long-term capital gains rates.⁷¹ Congress has looked to change the tax treatment of performance fees and "carried interest" at different times in the past, but now with increased pressure from the Obama administration to close tax loopholes and with added pressure to increase revenue, Congress may act soon to classify performance fees as ordinary income.⁷²

It is important to note that a significant portion of the hedge-fund industry is made up of hedge funds that invest only in other hedge funds.⁷³ These hedge funds, which invest in an assortment of other hedge funds and are commonly known as "funds of funds," can be quite large.⁷⁴ Their goal is

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *See id.*

⁶⁹ *Growth of a \$1000 Dollar Chart For HHFI and Benchmarks (1987–2010)*, HENNESSEE GROUP LLC, <http://www.hennesseegroup.com/indices/returns/dollargrowth.html> (last visited Mar. 25, 2012). The graph from Hennessee represents how hedge funds generally outperform the overall market, even during the recent economic crisis. The market is sometimes used as a benchmark for so-called "preferred-return" or "high-water mark" calculations.

⁷⁰ Laura Saunders, *Tax Report: 'Carried Interest' in the Cross Hairs*, WALL ST. J., Aug. 6, 2011, at B9.

⁷¹ *Id.*

⁷² *Id.* For an in depth discussion of the controversy surrounding the "carried interest," see also *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773 (2011); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008).

⁷³ Cassell Bryan-Low, *Not Much Fun Now With the Fund of Funds*, WALL ST. J., Oct. 3, 2008, at C1.

⁷⁴ *Largest Hedge Fund of Fund Managers*, INVESTMENT NEWS (Sept. 22, 2008, 6:01 AM), <http://www.investmentnews.com/article/20080922/CHART/809199974>.

to diversify risk across a “basket” of hedge funds⁷⁵ and to provide an average hedge-fund investor exposure to more funds than it would otherwise be able to invest in (because the minimum investment requirements of each fund in the basket may be prohibitive). Because fund of funds invest exclusively in other hedge funds, their investors pay a second layer of fees.⁷⁶ As an investor in another hedge fund, a fund of funds pays a management fee on the assets it invests and also pays an incentive fee on any gains that are passed through to it, creating the first layer of fees.⁷⁷ The fund of funds then charges its own management fee (up to 1.5%) and incentive fee (5 to 10% on gains), creating a second layer of fees which it passes through to its investors.⁷⁸ These funds, with their fee-layering and large size, face administrative difficulties, including decreased investment liquidity from the underlying funds, and as a result many are forced to hold more of their assets in cash at certain times in order to meet redemption requests.⁷⁹

E. The Documents that Control Hedge-Fund Partnerships

Hedge-fund offering documents generally are similar to a mutual fund prospectus and contain three main documents: a private placement memorandum; a limited partnership agreement; and a set of subscription documents.⁸⁰ Hedge-fund managers use detailed operating agreements to structure their funds and to define the rights and duties of the general partner and limited partners.⁸¹ The legal rights of limited partners are determined by the limited partnership agreement.⁸² Delaware limited partnership law is seen as enabling and generally allows the parties to structure the different aspects of the partnership agreements, including capital redemptions, as they see fit.⁸³ The flexibility of partnership law does not practically limit the way an operating agreement is structured.⁸⁴

⁷⁵ Bryan-Low, *supra* note 73.

⁷⁶ *Id.*

⁷⁷ Shadab, *supra* note 11, at 250.

⁷⁸ Bryan-Low, *supra* note 73.

⁷⁹ *Id.*

⁸⁰ Bart Mallon, *Hedge Fund Offering Documents*, HEDGE FUND L. BLOG (Aug. 3, 2008), <http://www.hedgefundlawblog.com/monthly-feature-hedge-fund-offering-documents.html>.

⁸¹ Shadab, *supra* note 11, at 249.

⁸² HAMMER ET AL., *supra* note 14, at 97.

⁸³ See generally DEL. CODE ANN. tit. 6, § 17-702(a) (2011); Ron S. Geffner, *Delaware—The Hedge Fund Jurisdiction of Choice in the US* (Feb. 11, 2008) (on file with author). According to Mr. Geffner, the flexibility and ease of creation provided by Delaware partnership law make it the preeminent choice for domestic hedge funds.

⁸⁴ Shadab, *supra* note 11, at 249.

As mentioned previously, limited partners retain almost no control over their investments, other than to redeem their capital; and the flexibility of the law allows them to voluntarily give up that decision-making ability through the operating agreement.⁸⁵ Hedge funds generally make only private offerings to potential investors⁸⁶ using private offering memorandums, which often contain information about a fund's structure and investment strategy.⁸⁷ On the one side, hedge-fund managers, desiring to maintain regulatory exemptions, make private offerings with documents that are generally one-sided and not fully negotiated. While on the other side, hedge-fund investors, desiring to maintain limited liability, willingly accept the lack of control outlined in the agreements. This dynamic gives rise to the problem where investors do not have the power to redeem their capital because they have given managers the right to suspend such redemptions.

III. HOW DO LIMITED PARTNERS ENTER AND EXIT A HEDGE FUND?

This section will examine the process and mechanics by which investors join and leave hedge funds. Typically, when a manager solicits an investment, it will give a prospective hedge-fund investor a private placement memorandum, sometimes called the offering document.⁸⁸ These documents must provide the investors with similar information to what would be available for public offerings including: a description of the business, the investment interest being offered, important risk factors about the fund, information about the investment strategy, use of the investor's subscription proceeds and length of the "lock-up" period.⁸⁹ However, because these documents are private and because managers desire to keep their actual investment positions secret, the offering documents tend to be vague in their description of the fund and its investments, and the prospective investor is unlikely to glean much meaningful information from them.⁹⁰ If the investor decides to enter the fund as a limited partner, it will receive the operating agreement or partnership agreement, which fully details the rights and duties of the parties.⁹¹ The investor will also receive subscription documents that detail the terms of purchase,⁹² which it must

⁸⁵ *Id.* at 247-48.

⁸⁶ 15 U.S.C. § 77d(2) (2006).

⁸⁷ Shadab, *supra* note 11, at 258.

⁸⁸ Mallon, *supra* note 80.

⁸⁹ Shadab, *supra* note 11, at 258 (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-26 (1953)).

⁹⁰ Ryan Sklar, Note, *Hedges or Thickets: Protecting Investors From Hedge Fund Managers' Conflicts of Interest*, 77 *FORDHAM L. REV.* 3251, 3322 (2009).

⁹¹ HAMMER ET AL., *supra* note 14, at 97.

⁹² *Id.*

execute and return, usually accompanying its actual cash investment into the fund.⁹³

A. *Entering a Hedge Fund*

The offering memorandum, partnership agreement or subscription documents will outline the strategy and restrictions of the investment, the length of the “lock-up” period and the amount of management and incentive fees that will be charged on the investment.⁹⁴ Many funds lock-up investors for a minimum period of time upon their subscription into the fund by disallowing redemptions, usually for six to twenty-four months.⁹⁵ Some managers provide tiered fee structures through which they allow investors to opt for longer lock-up periods in order to incur lower fees.⁹⁶ However, lock-up periods have historically been short,⁹⁷ and in the wake of the recent economic crisis, investors have increasingly been able to bargain for decreased fees and reduction or elimination of lock-up periods.⁹⁸

Different funds have different liquidity periods based on their investment strategy.⁹⁹ For example, some hedge funds have strategies similar to private equity funds (typically longer-term and less liquid than hedge funds) and therefore cannot offer liquidity like a normal “long-short” hedge fund that invests only in stocks or other short-term investments.¹⁰⁰ While this lack of liquidity may seem harsh, it is fully disclosed by the manager and accepted by the investor prior to the investor’s subscription of capital.¹⁰¹

Fund of funds have unique liquidity concerns, not the least of which is the differing lock-up periods for its underlying investments.¹⁰² As a result, fund of funds often require longer notice periods for their investors’ redemption requests, because they in turn must make redemption requests

⁹³ Mallon, *supra* note 80.

⁹⁴ HAMMER ET AL., *supra* note 14, at 96–97.

⁹⁵ *Id.* at 3.

⁹⁶ Bei Hu, *Hedge Funds Lower Fees, Lengthen Lockups on New Funds*, BLOOMBERG (Dec. 3, 2008, 12:49 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aV5d_zNyBLfM&refer=home.

⁹⁷ Oesterle, *supra* note 16, at 4.

⁹⁸ *Exit Plan*, *supra* note 20.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Bart Mallon, *Hedge Fund Redemptions and the Gate Provision*, HEDGE FUND L. BLOG (Sept. 29, 2008), <http://www.hedgefundlawblog.com/hedge-fund-redemptions-and-the-gate-provision.html>.

¹⁰² David Shastri, *Painting a Clearer Picture: Fund of Funds are In Search of Clarity in Their Cash Flow*, HEDGE FUND J. (Dec. 2007), <http://www.thehedgefundjournal.com/magazine/200712/technical/funds-of-funds-are-in-search-of-clarity-in-their-cash-flow.php>.

from their portfolio funds.¹⁰³ If a hedge fund has enough short-term or liquid assets to meet its redemption requests, it would have few reasons to lower a "gate," and even if it did not have liquid enough assets for redemptions, the fund is not required to suspend redemptions.¹⁰⁴ However, major problems can arise for both hedge funds and fund of funds when such funds are invested in illiquid or thinly traded positions (including other hedge funds) and receive redemption requests that exceed the amount of their short-term or liquid assets.¹⁰⁵

B. *Exiting a Hedge Fund*

Hedge funds have different redemption procedures than other investment vehicles such as private equity funds or mutual funds.¹⁰⁶ One of the main differences between a hedge fund and a private equity fund is the frequency with which investors can liquidate their investment and gain access to the proceeds.¹⁰⁷ Once a limited partner's capital is available for redemption (after the initial lock-up period), it must give appropriate notice of redemption in order to receive its redemption proceeds.¹⁰⁸ The notice periods are typically thirty days for a fund with monthly liquidity provisions or sixty to ninety days for funds with quarterly or annual liquidity provisions.¹⁰⁹ In contrast to mutual funds, which are valued daily, hedge funds are usually only valued on a monthly or quarterly basis.¹¹⁰ If an investor has made a proper redemption request, then it can receive its redemption proceeds after the net asset value (the "NAV") of a fund is "struck".¹¹¹ Funds typically apply a 10% holdback to redemption payments for any year-end audit adjustments that might take place (and pay out the balance of the redemption after the audit is signed).¹¹² Because hedge funds can have very short redemption periods, managers have designed tools for stemming the outflow of assets, namely redemption gates.

¹⁰³ *Id.*

¹⁰⁴ Mallon, *supra* note 101.

¹⁰⁵ *Fistful of Dollars*, *supra* note 21.

¹⁰⁶ Jonathan Bevilacqua, Note, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 262 (2006).

¹⁰⁷ *Id.*

¹⁰⁸ SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 2:3.3 (2007).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* § 2:2.4.

¹¹¹ Mallon, *supra* note 101.

¹¹² Shastri, *supra* note 102.

IV. HEDGE-FUND "GATES": WHAT ARE THEY AND WHY ARE THEY NECESSARY?

This section first will examine what redemption gates are and how they function. Second, it will discuss the positive aspects and economics benefits of imposing gates. Third, it will examine the events of the economic crisis that caused many hedge-fund managers to impose gates. Lastly, it will discuss the negative consequences of imposing gates and the possibility of their inappropriate use.

A. *What are Gates?*

A hedge-fund gate is a mechanism used to limit the amount of assets that can be withdrawn from a fund during any one redemption period.¹¹³ If a hedge-fund investor requests the return of its capital that is eligible for redemption, the manager may deny the request under certain circumstances.¹¹⁴ Most hedge-fund agreements give the managers the option to restrict or suspend investor redemptions if the aggregate amount of redemptions goes above a predetermined percentage (usually 20%, but sometimes as low as 10%, of the fund's assets).¹¹⁵ Investors have the option to try to force a liquidation of the fund¹¹⁶ (a "winding-up," almost an equivalent to a hedge-fund bankruptcy), but for reasons set out later in this note, forcing a liquidation may not always be in the best interest of the investors.¹¹⁷ When redemptions are restricted or gated, the manager will calculate the total amount of the funds' capital available for redemption based on the agreed upon percentage, and then return that capital on a pro-rata basis among the redeeming investors based on the amount of each request.¹¹⁸

Generally, after a gate has been imposed, there is no stated time by which it must be lifted.¹¹⁹ In fact, some offering documents allow managers to completely suspend redemptions if there is a major or catastrophic event that impairs the value of the portfolio.¹²⁰ Not until recently were the mechanics and reasoning behind hedge-fund gates understood or

¹¹³ Bart Mallon, *What is a "Gate" Provision?*, HEDGE FUND L. BLOG (Aug. 1, 2008), <http://www.hedgefundlawblog.com/what-is-a-gate-provision.html>.

¹¹⁴ LEDERMAN, *supra* note 108.

¹¹⁵ Mallon, *supra* note 113.

¹¹⁶ *Bashing Yields Little*, *supra* note 23.

¹¹⁷ See discussion of timing issues with investor redemption requests and hedge-fund liquidations, *infra* Part IV.B.

¹¹⁸ Mallon, *supra* note 101.

¹¹⁹ *Fistful of Dollars*, *supra* note 21.

¹²⁰ Mallon, *supra* note 101.

scrutinized so heavily.¹²¹ Prior to 2008, most investors never envisioned a scenario where funds would be gated in mass.¹²² With the benefit of hindsight, many investors see an investment's liquidity as a top priority when seeking new investments and exiting current investments.¹²³

Hedge funds use another common strategy that is similar to a redemption gate to mitigate the loss of their capital, known as "side-pocketing."¹²⁴ Side pockets are used to segregate and match redemption requests with illiquid assets.¹²⁵ The side pocket allows a manager to "clean-up" some illiquid investments before paying out redemptions; however some investors who requested redemptions two to three years ago are still awaiting their full return of capital because they were placed in a side pocket.¹²⁶

B. *Are Gates Necessary?*

In general, hedge funds use liquidity restrictions (e.g. not allowing their shares to be traded) in order to maintain their regulatory exemptions and to maintain their preferred partnership structure (with its incumbent tax benefits).¹²⁷ While the necessity of hedge-fund gates has been hotly debated lately,¹²⁸ it is clear that funds will continue to use gates as long as investors continue to agree to them.¹²⁹ There are pros and cons on either side of the debate and this note will discuss them in turn.

1. *Positive Aspects of Imposing a Gate*

There are economic benefits that can be gained by imposing a redemption gate. Gating excess redemption requests may benefit the fund (and the investors) in the long-term, because a large redemption of capital

¹²¹ *Exit Plan*, *supra* note 20.

¹²² *Fistful of Dollars*, *supra* note 21.

¹²³ *Id.*

¹²⁴ Matthew A. Feldman & Jennifer L. Dudanowicz, *Hedge Fund Liquidations: Deciding What To Do When Investors Ask For Their Money Back*, 241 N.Y. L.J. 9 (2009), available at http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2914%5CHedge%20Fund%20Liquidations.pdf. For further discussion of the recent use and abuse of "side pocketing," see Jenny Strasburg, *SEC Probes 'Side Pocket' Arrangements*, WALL ST. J., Apr. 28, 2010, at C1.

¹²⁵ Feldman & Dudanowicz, *supra* note 124.

¹²⁶ Christine Williamson, *Hedge Funds Have \$100 Billion Still Locked Up*, PENSIONS & INVS., (May 26, 2011), <http://www.pionline.com/article/20110516/PRINTSUB/305169963/>.

¹²⁷ LEDERMAN, *supra* note 108.

¹²⁸ Peter Lattman & Jenny Strasburg, *Clients Flee Cerberus, Fallen Fund Titan*, WALL ST. J., Aug. 29, 2009, at A1.

¹²⁹ See Eder, *supra* note 25.

at a given time may disrupt the fund's operations and force the fund to act inconsistently with its trading strategy.¹³⁰ Gating excess redemption requests helps to protect the fund's assets because hedge funds often hold large positions in illiquid assets and requiring a fund to liquidate such positions would likely cause severe impairment to the investment value.¹³¹

The fund wants to prevent having to unload assets at discounted price resulting from a "run on the fund"; this untimely liquidation inadvertently punishes the remaining investors while only benefiting the liquidity (and not necessarily the economic position) of exiting investors.¹³² Investors tend to get antsy when they cannot access to their money,¹³³ but just because an investment lacks liquidity, it is not necessarily a bad investment.¹³⁴ Often illiquid investments realized sizable gains when they eventually become liquid.¹³⁵ Some funds in 2009 were even raising capital to invest in certain illiquid investments being dumped on the market by other funds that had to satisfy "runs" (due to the glut of investor redemptions at the time).¹³⁶

Another reason for imposing gates is that funds sometimes hold large ownership percentages of particular investments (not necessarily illiquid investments). Funds that hold such large positions of particular investments want to avoid selling such positions at "fire-sale" prices. While a portfolio's value impairment from a fire-sale is similar to that from a run on the fund described above, it has different economic forces behind it. It is evident that some believe that gates can be used to prevent fire-sales and runs on the fund.¹³⁷ Although some might argue differently,¹³⁸ using a gate to protect against a fire-sale or run caused by investor panic benefits all the investors by preventing the spiraling effect caused by the panic. Large hedge funds can hold very large positions in certain investments, as evidenced by Cerberus Capital Management's recent struggles.¹³⁹ Such large funds would not be wise to liquidate their entire positions instantaneously, because doing so would require them to artificially increase the supply (and decrease the selling price) of such positions in the market.¹⁴⁰ This increased supply would inevitably decrease the remaining value in the portfolio.¹⁴¹ The fund,

¹³⁰ Shadab, *supra* note 11, at 252.

¹³¹ Feldman & Dudanowicz, *supra* note 124.

¹³² *Id.*

¹³³ Williamson, *supra* note 126.

¹³⁴ *Exit Plan*, *supra* note 20.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Fistful of Dollars*, *supra* note 21.

¹³⁹ Lattman & Strasburg, *supra* note 128.

¹⁴⁰ *Fistful of Dollars*, *supra* note 21.

¹⁴¹ *Id.*

by essentially dumping the value of part of its portfolio into the market to satisfy redemption requests, would impair the portfolio's value for all the investors, exiting and remaining.¹⁴² This impairment is only exacerbated when dealing in thinly traded investments.¹⁴³ Interestingly, this "crisis" mentality and rush for the exits by investors has actually created investment opportunities over the past few years.¹⁴⁴

Lastly, it is important to note that many managers who imposed gates saw a major rebound in 2009.¹⁴⁵ The industry has lauded the use of gates as a mechanism that functioned exactly as it was designed, to preserve investor capital.¹⁴⁶ However, because of the continued delay by many funds in paying out redemptions,¹⁴⁷ some investors are not convinced that the managers used these tools for capital preservation, but rather believe that managers used them for self-preservation.¹⁴⁸

2. *The Recent Economic Crisis' Role in Accentuating the Different Aspects of Gates*

The 2008 financial crisis saw the collapse of the Lehman Brothers.¹⁴⁹ This was an event no one envisioned because many believed the United States Department of the Treasury and the Federal Reserve would step in as a backstop.¹⁵⁰ The Treasury Department refused to step in because it feared that it was promoting moral hazard, since it had already helped avert bankruptcy at Bear Sterns earlier in the year.¹⁵¹ Because the Secretary of the Treasury, Henry Paulson, was formerly employed with Goldman Sachs and because of his ties within the industry, some accused him of pettiness and favoritism in saving Bear Sterns and not Lehman Brothers.¹⁵² In hindsight, however, Mr. Paulson and the Treasury Department probably would have acted to avert the bankruptcy at Lehman Brothers also.¹⁵³ The Lehman Brothers collapse set off a global financial crisis,¹⁵⁴ and in its wake a ponzi scheme run by Bernard Madoff was uncovered, which turned out to be the

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Exit Plan*, *supra* note 20.

¹⁴⁵ Schwartz & Story, *supra* note 58.

¹⁴⁶ *Exit Plan*, *supra* note 20.

¹⁴⁷ Williamson, *supra* note 126.

¹⁴⁸ *Bashing Yields Little*, *supra* note 23.

¹⁴⁹ *Exit Plan*, *supra* note 20.

¹⁵⁰ *Frontline: Inside the Meltdown* (PBS television broadcast Feb. 17, 2009), available at <http://www.pbs.org/wgbh/pages/frontline/meltdown/view/> [hereinafter *Inside the Meltdown*].

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

largest investor fraud in history.¹⁵⁵ Many of Mr. Madoff's clients were hedge funds and their sudden demise set off a panic among hedge-fund managers and investors.¹⁵⁶ Mr. Madoff was convicted of defrauding investors of almost \$13,000,000,000,¹⁵⁷ and his fraud likely would have gone undiscovered if not for the unprecedented financial meltdown.¹⁵⁸ These major banking collapses and hedge-fund fraud served as the backdrop for the unprecedented fund withdrawals and fund liquidations that took place in 2008.¹⁵⁹

3. *Negative Aspects of Imposing a Gate*

There are some reasons for imposing redemption gates that are not so altruistic, and even managers with positive intentions can cause negative or unintended consequences by imposing gates. The uncertainty and fear created by Mr. Madoff's scheme reverberated far and wide through the hedge-fund industry,¹⁶⁰ causing the winding-up of many hedge funds,¹⁶¹ including large and notable funds like Cerberus Capital Management's flagship fund¹⁶² and the Fairfield Greenwich Group.¹⁶³ Because of the unprecedented crisis in the industry in 2008 and 2009, many funds, even those who did their due diligence, were left with massive losses; yet many managed to stay open through the use of redemption gates and liquidity restriction.¹⁶⁴ Some have argued that the use of gates in that situation rewarded bad behavior and shortsighted managers,¹⁶⁵ and the industry is still uncovering fraud even today.¹⁶⁶ Even though redemption gates are

¹⁵⁵ *Frontline: The Madoff Affair* (PBS television broadcast May 12, 2009), available at <http://video.pbs.org/video/1122731028/>.

¹⁵⁶ *Id.*

¹⁵⁷ Robert Frank & Amir Efrati, "Evil" Madoff Gets 150 Years in Epic Fraud—Victims Cheer Tough Sentence; Judge Slams Financier for Stonewalling Investigators; True Size of Losses Still a Mystery, *WALL ST. J.*, June 30, 2009, at A1.

¹⁵⁸ *Inside the Meltdown*, *supra* note 150.

¹⁵⁹ Emily Chasan, *Special Report: How Investors Turned the Tables on Hedge Funds*, *REUTERS*, Mar. 17, 2011, available at <http://graphics.thomsonreuters.com/11/03/HedgeFunds.pdf>.

¹⁶⁰ *Inside the Meltdown*, *supra* note 150.

¹⁶¹ Chasan, *supra* note 159. The graphs in Ms. Chasan's article demonstrate the backdrop in which many of the gate provisions were enacted in 2008 and 2009. One shows the staggering amount of fund closures that resulted from the economic crisis and another represents the net cash outflow from many funds that suffered from large redemptions.

¹⁶² Lattman & Strasburg, *supra* note 128.

¹⁶³ *Inside the Meltdown*, *supra* note 150.

¹⁶⁴ *Fistful of Dollars*, *supra* note 21.

¹⁶⁵ *Id.*

¹⁶⁶ Daily Mail Reporter, *British Fund Manager Michael Balboa Faces Fraud Charges*, *THIS IS MONEY* (Dec. 2, 2011), <http://www.thisismoney.co.uk/money/>

extremely common across all hedge-fund strategies,¹⁶⁷ they usually leave investors unhappy about not gaining access to their investment capital.¹⁶⁸ Because many of the agreements do not have time limits for gate impositions, the managers can use their "investment discretion" to effectively keep the fund open and continue charging management and incentive fees in perpetuity (or at least until the fund gets sued).¹⁶⁹

Hedge-fund gates can and do create negative consequences, including fund managers lowering gates to simply keep funds open in order to collect fees, the spiraling effect from investor panic that can lead to a fund's demise¹⁷⁰ and a liquidation problem surrounding which investors are creditors and which are equity holders.¹⁷¹ The first problem arises because managers can collect management fees regardless of the performance of the fund. Therefore, managers can unscrupulously lower gates in order to continue collecting their management fees on the gated assets.¹⁷² Because there are many different reasons that a manager may decide to lower a gate (other than purely self-preservation) an investor action trying to force the redemption of an investment will probably be difficult to win unless there is proof of only self-serving reasons.¹⁷³

The second problem is essentially a confidence problem that goes on between investors and a fund's lenders.¹⁷⁴ The fund lowers a gate because investors are afraid of losses and want to redeem too much of the fund's capital immediately.¹⁷⁵ Once the fund suspends or restricts redemptions, the lenders learn that the fund may possibly be going under.¹⁷⁶ The fund's lenders in turn raise the borrowing costs of the fund, thereby further pressuring its cash position.¹⁷⁷ The fund's other counterparties may also exploit the situation by lowering their bids for the fund's assets, thereby forcing the fund to sell a larger percentage of its position and lose more money.¹⁷⁸ The idea behind a fund's lowering of a gate is to preserve assets and meet redemption requests in an orderly fashion, with the ultimate goal

markets/article-2069355/British-fund-manager-Michael-Balboa-faces-fraud-charges.html?ito=feeds-newsxml.

¹⁶⁷ Mallon, *supra* note 113.

¹⁶⁸ *Exit Plan*, *supra* note 20.

¹⁶⁹ Williamson, *supra* note 126.

¹⁷⁰ *Fistful of Dollars*, *supra* note 21.

¹⁷¹ Feldman & Dudanowicz, *supra* note 124.

¹⁷² *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. CIV.A.5502-CS, 2011 WL 3505355, at *13 (Del. Ch. Aug. 8, 2011).

¹⁷³ *Id.* at *32.

¹⁷⁴ *Fistful of Dollars*, *supra* note 21.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

of lifting the gate and continuing operations.¹⁷⁹ However, many funds fail to achieve that goal because investors and creditors are unwilling to wait for the fund's investment strategy to create enough liquidity to survive.¹⁸⁰ The fund must eventually wind-up and go into liquidation to meet their outstanding obligations.¹⁸¹

Another negative consequence of lowering a gate comes when a fund actually liquidates and there are disputes between investors regarding the distribution of the fund's assets. If a gate is lowered and the fund eventually liquidates, there are likely three types of investors: early redeemers, late redeemers, and non-redeemers (or forced-redeemers).¹⁸² The different investors can actually end up with rights to fund assets that are not entirely based on their ownership of the fund's equity.¹⁸³ It might not make sense that some investors would want to remain in the fund, even in the face of possible bankruptcy, but the following spells out their reasoning:

[A] critical issue faced by liquidating hedge funds is how to treat early redeeming investors as compared to later redeeming investors as compared to non-redeeming investors. It is common, even for funds that have received an unacceptably high volume of redemptions preventing them from continuing to operate in the ordinary course, for some investors not to have given notice of redemption. Typically, these non-redeeming investors have determined that they would rather continue owning the "equity" of the fund on the theory that asset values will recover quickly, permitting them a greater recovery than if they redeemed.¹⁸⁴

Disputes arise between investors because the way they are prioritized in a liquidation, disproportionately to their equity stake, can greatly affect the actual redemption amount.¹⁸⁵ Early redeemers in a hedge-fund liquidation will likely argue that they are creditors and not equity holders, because their redemption requests came before the fund began liquidation and therefore they are no longer partners in the fund.¹⁸⁶ The Delaware Chancery Court has supported the finding that a withdrawn limited partner becomes a contract claimant, by stating, "logically and consistent with the plain meaning of the Delaware Revised Uniform Partnership Act §17-606(a), it is

¹⁷⁹ Williamson, *supra* note 126.

¹⁸⁰ *Fistful of Dollars*, *supra* note 21.

¹⁸¹ *Id.*

¹⁸² Feldman & Dudanowicz, *supra* note 124.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

the partnership that owes the distribution to the creditor (i.e., the withdrawn limited partner).¹⁸⁷ Non-redeemers in a hedge-fund liquidation will argue against such an approach.¹⁸⁸ They will point out that the timing of the redemption should not change the true underlying character of the partnership, and as such, the remaining assets should be split between the investors in proportion to their percentage of equity in the fund.¹⁸⁹ After a fund's eventual liquidation, and with the benefit of hindsight, this argument makes sense from a fairness perspective.

Late-redeemers in a hedge-fund liquidation face a problem as to which approach they should take when arguing for their redemption assets.¹⁹⁰ A late-redeeming investor can argue that it should be paid their redemption on a pro-rata basis, similar to what the non-redeeming investor would argue.¹⁹¹ However, if the early-redeeming investor prevails with its argument, the late-redeeming investor will receive less than it would if it had argued "with" the early-redeeming investor.¹⁹² It makes sense for the late-redeeming investor to argue with early-redeeming investor, that it is owed as a creditor and not an equity holder, because it can benefit at the expense of the non-redeeming investor.¹⁹³ However, if both the early and late-redeeming investors prevail in their arguments, the non-redeeming investor may lose out on most, if not all, of its remaining capital, simply because it waited to redeem until after the fund shut down.¹⁹⁴ It seems illogical to punish a hedge-fund investor who remained in a failing fund a little longer than a comparably situated investor who simply submitted its redemption request earlier. These negative and unintended consequences and manager self-preservation issues not only highlight the problems with fund managers imposing gates, but also undermine the perceived necessity of these mechanisms.

V. HOW HAVE DELAWARE COURTS HANDLED CLAIMS BROUGHT BY INVESTORS' SEEKING THE RETURN OF THEIR GATED ASSETS?

This section will discuss the recent Delaware Chancery Court opinion involving a hedge-fund manager's abuse of a redemption gate provision. First, it will examine the events leading up to the litigation, including the

¹⁸⁷ *Schuss v. Penfield Partners, L.P.*, No. CIV.A.3132-VCP, 2008 WL 2433842 at *4 (Del. Ch. June 13, 2008).

¹⁸⁸ *Feldman & Dudanowicz*, *supra* note 124.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Feldman & Dudanowicz*, *supra* note 124.

creation, operation and effective end of Paige Capital. Second, it will review Chancellor Strine's opinion regarding the contract issues in the case. Finally, and most importantly, it will discuss the fiduciary duties that the Court found were owed in the context of hedge-fund managers imposing redemption gates.

A. Paige Capital—Creation, Inaction and Demise

In the *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC* decision, Chancellor Strine of the Delaware Chancery Court provided a two-pronged approach for dealing with redemption gate disputes (examining both the nature of the separately negotiated contracts and the breach of fiduciary duties).¹⁹⁵ The facts of the case provided an interesting backdrop that allowed Chancellor Strine to explore common issues with hedge-fund redemption gates. After a successful run at the hedge fund King Street, Michele Paige decided to create her own hedge-fund operation.¹⁹⁶ As is common with hedge-fund organization, Ms. Paige, along with her husband Christopher Paige, created four different entities to operate their hedge fund.¹⁹⁷ To organize their investment operation, they actually created two different funds, which included an onshore fund and an offshore fund.¹⁹⁸ The entities involved included: 1) Paige LP, the onshore fund; 2) Paige Opportunity Master Fund, Ltd. (Paige Ltd) the offshore fund; 3) Paige Capital Management, LLC (Paige Capital), the investment adviser; and 4) Paige GP, LLC (Paige GP), the general partner for Paige LP.¹⁹⁹ The Courts discussion of entity structure here illustrates just how complex these agreements can be and it demonstrates that these agreements are not simply one-to-one transactions, but rather involve multiple entities contracting with one another.²⁰⁰

When creating a hedge fund, managers often look to core investors to give them a substantial amount of assets.²⁰¹ This helps to legitimize the fund and attract new investors.²⁰² The early investors can often negotiate

¹⁹⁵ *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. CIV.A.5502-CS, 2011 WL 3505355 (Del. Ch. Aug. 8, 2011). Although this is an unpublished Memorandum Opinion from the Delaware Chancery Court, it carries significant weight because of the sheer volume of hedge funds that are organized in the state of Delaware. See Geffner, *supra* note 83 (noting the preeminence of Delaware in hedge-fund organization).

¹⁹⁶ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *3.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.* See discussion of hedge-fund entity structures *supra* Part II.B.

²⁰¹ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *3.

²⁰² *Id.*

favorable terms, which may give them reduced fees or allow them to share in the management fees or incentive fees on subsequent gains charged to other investors.²⁰³ Such terms are often added through side agreements that are negotiated separately from the partnership agreement and subscription documents.²⁰⁴ The Lerner Master Fund, LLC (Lerner Fund) was an early and substantial investor in Paige LP and Paige Ltd, and as such, was able to negotiate a separate agreement (Seeder agreement).²⁰⁵ During the negotiations of the side agreement, there was much debate whether the partnership agreement (which contained a gating provision) or the Seeder agreement would be the controlling document.²⁰⁶ The Seeder agreement required a three-year lock-up of the Lerner Fund's initial investment, which totaled \$40,000,000.²⁰⁷ The Seeder agreement also provided the Lerner Fund with reduced fees, a share of the fees earned from the future investors and increased information rights, while imposing significant penalties for any attempt to withdrawal the investment before the end of the lock-up period.²⁰⁸ The Paiges made it clear that they did not intend the Seeder agreement to supersede the partnership agreement.²⁰⁹

The partnership agreement and Seeder agreement were executed in late 2007,²¹⁰ shortly before the hedge-fund industry began to suffer substantial losses resulting from the recent financial crisis.²¹¹ Through fear, inaction and ineptitude, Ms. Paige failed to deploy any significant capital during 2007 and 2008, and as a result did not earned any significant returns.²¹² Because of market forces (and probably because the lack of any real investor gains), Paige Capital failed to attract any new investors (which were supposed to provide the fees which were the upside for the lock-up risk the Lerner Fund had assumed).²¹³ In late 2008, Mr. Lerner (along with many investors) began to reassess his portfolio to increase liquidity and focus on operating companies, rather than maintaining passive investments.²¹⁴ Through four different meetings with Ms. Paige during that time, the Lerner Fund became aware of her lack of action, both in investing Paige Capital's assets and in attracting new investors (or even any prospects for new investors).²¹⁵ After this, the Lerner Fund communicated its desire to

²⁰³ *Id.*

²⁰⁴ *Id.* at *4.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *4.

²⁰⁸ *Id.* at *5.

²⁰⁹ *Id.* at *4.

²¹⁰ *Id.*

²¹¹ Checkler, *supra* note 19.

²¹² *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *5.

²¹³ *Id.*

²¹⁴ *Id.* at *6.

²¹⁵ *Id.*

redeem its investment at the end of the lock-up period, as provided by the Seeder agreement.²¹⁶ In 2009, in spite of these concerns raised by the Lerner Fund, Ms. Paige still did not deploy Paige Capital's assets because she thought the market was going to head lower.²¹⁷ However, her strategy was terribly misguided, as the market rebounded strongly in 2009.²¹⁸

As the end of the three-year lock-up period approached, the Lerner Fund renewed its intentions to withdraw its investment and filed a redemption notice with Paige Capital in accordance with the Seeder agreement.²¹⁹ The redemption notice caused the Paiges to react angrily by threatening to gate the Lerner Fund's assets in accordance with the partnership agreement.²²⁰ The Paiges then filed a declaratory judgment action seeking to enact the redemption gate on the Lerner Fund's assets.²²¹ The Lerner Fund then filed its counterclaims against Paige Capital seeking the return of its assets.²²² Chancellor Strine's analysis was two-pronged, focusing on the contract issues at work in the dispute and on the fiduciary duties owed by the Paiges (as fund managers) to the Lerner Fund (an investor in Paige LP and Paige Ltd).²²³

B. Paige Capital—Separately Negotiated Contracts

Chancellor Strine found the differences in the contracts and the intentions of the parties to be dispositive in the case.²²⁴ He focused specifically on the differences between the redemption rights provisions contained in the two agreements.²²⁵ The question at issue was whether the Seeder agreement prevented the imposition of a redemption gate that was specifically authorized by the partnership agreement.²²⁶ Although the Seeder agreement expressly said that it should not amend or supersede the partnership agreement, Chancellor Strine found that the agreements, taken together and in light of the intentions of the parties, did not contemplate a redemption gate being lowered on the Lerner Fund at the end of the lock-up period.²²⁷ The Court found that if the Seeder agreement were meant to be used in conjunction with a redemption gate, it would not have been silent

²¹⁶ *Id.* at *7.

²¹⁷ *Id.* at *12.

²¹⁸ Schwartz & Story, *supra* note 58.

²¹⁹ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *12.

²²⁰ *Id.* See discussion of Christopher Paige's letter to the Lerner Fund *supra* Part I.

²²¹ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *14.

²²² *Id.* at *15.

²²³ *Id.* at *2.

²²⁴ *Id.* at *16–28.

²²⁵ *Id.* at *14.

²²⁶ *Id.*

²²⁷ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *16–28.

on the issue.²²⁸ The Court ruled that the Seeder agreement was the controlling document that was negotiated between the parties and that it was not susceptible to more than one meaning.²²⁹ As such, it would have been improper to use extrinsic evidence (e.g. the partnership agreement argued for by the Paiges) to try to further interpret the Seeder agreement, which was sufficiently clear with regard to the issue of redemption gates.²³⁰ The Court determined that the Paiges contractually waived the redemption gate provision of the partnership agreement by negotiating a side agreement that with the Lerner Fund that was silent on redemption gates.²³¹

C. *Paige Capital—Breach of Fiduciary Duty*

Although Chancellor Strine found the contract issue to be dispositive, the most important aspect of this case was not whether the contracts should be read either in conjunction or independently of one another. Rather, the most important aspect for hedge-fund investors was Chancellor Strine's discussion of fiduciary duties owed by fund managers to hedge-fund investors.²³² The Court found that the Paiges breached their fiduciary duty to the Lerner Fund as an investor by seeking to impose a redemption gate for purely selfish reasons.²³³ He found that the Lerner Fund could have withdrawn its assets on that basis alone.²³⁴ Mr. Lerner acknowledged that the redemption gate provision was present, but he also looked to other language in the same clause to show that the Paiges did not fulfill their fiduciary duties.²³⁵ The redemption clause was clear and unambiguous relating to the ability of the manager to impose redemption restrictions if more than 20% of the fund's assets were requested at any withdrawal date.²³⁶ However, the clause also stated that the manager, at its sole discretion could waive or modify the gate for certain large or strategic investors.²³⁷ Mr. Lerner argued that because the Lerner Fund was undeniably large and strategic for Paige Capital Management, the failure by the Paiges to consider "in good faith" waiving the clause for the Lerner Fund was a breach of fiduciary duty.²³⁸ Mr. Lerner argued that as a result of

²²⁸ *Id.* at *18.

²²⁹ *Id.* at *22.

²³⁰ *Id.*

²³¹ *Id.* at *28.

²³² *Id.* at *28–35.

²³³ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *28–35.

²³⁴ *Id.*

²³⁵ *Id.* at *28.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

the breach of fiduciary duty, he was entitled to the return of his investment.²³⁹

The material showing the Paiges' intent to keep the assets locked-up merely to earn the management fees was the most persuasive evidence that the Court examined.²⁴⁰ The Court highlighted that Delaware allows the waiver of fiduciary duties in partnership agreements, but no such waiver was present in Paige Capital's partnership agreement.²⁴¹ Instead, Paige GP had a clear fiduciary duty to Paige LP, Paige Ltd and the investors, when deciding to impose a redemption gate.²⁴² The Court found that the reasons posited by the Paiges for desiring to impose the redemption gate were completely self-serving and not in the best interest of the funds or the investors.²⁴³ The Paiges did not present any rational reasons for imposing the gate, and the reasons that were presented merely showed their selfish intentions.²⁴⁴ Because the Paiges were so inept in the execution of their duties and because they were unable to show any reason for desiring to impose a redemption gate, the Court easily concluded that they had breached their duty by trying to impose the redemption gate.²⁴⁵ In other cases, it may be less clear, especially if the managers can present any legitimate reasons for imposing a gate.

VI. WHAT SOLUTIONS ARE AVAILABLE FOR INVESTORS AND MANAGERS TO MEET THEIR (SOMETIMES COMPETING) GOALS OF LIQUIDITY AND CAPITAL PRESERVATION?

In framing the problems of hedge-fund redemption gates as those of manager misappropriation and manager self-preservation, one ignores the reality that many managers are truly interested in creating investor gains (sometimes for selfish reasons) and many of them have their own personal fortunes tied up in their funds.²⁴⁶ However, many disputes arise because if any party has the opportunity and incentive to act improperly regarding redemption requests, it is the fund manager. Therefore, because the investors are the "consumers" of the hedge fund's services, solutions to these problems should focus on investor action. The most obvious and least cooperative (and probably least practical) solution is for investors simply not to invest with managers who have redemption gate provisions in the

²³⁹ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *28.

²⁴⁰ *Id.* at *32.

²⁴¹ *Id.* at *31.

²⁴² *Id.* at *32.

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Paige Capital Mgmt., LLC*, 2011 WL 3505355, at *32.

²⁴⁶ *Fistful of Dollars*, *supra* note 21.

offering documents. Until recently, this solution would not have been possible because nearly all partnership agreements included non-negotiable redemption gate provisions.²⁴⁷ Also, gates were not often used because their imposition signaled the effective end of a fund.²⁴⁸ Still, many investors probably do not have the bargaining power to affect such large changes to a hedge fund's operations.²⁴⁹ This solution (of removing gates altogether) remains unlikely, because most managers (and many investors) see the collective benefit in including redemption gate provisions and are willing to allow them for their beneficial purposes.²⁵⁰

If an investor chooses not to follow the adage of "voting with its feet," then it can seek the possibility of restructuring the gate provisions with the manager. One restructuring option would be to prevent managers from charging fees on gated assets. This would be a powerful tool to remove the short-term compensation incentive for managers imposing redemption gates. Restructuring can include an increase in the threshold of assets seeking redemption before a gate provision kicks in. Typically gate provisions allow for gates to be lowered after 20% or more of the funds assets have been sought for redemption.²⁵¹ Increasing this number to 40% or even 60% would severely limit the ability of managers to use gates. Because raising the percentage of assets would limit the use of gates to those funds who have only the most severe liquidity issues, this approach could result in the use of redemption gates again being the first step to effectively winding-up a fund. Some might argue that this defeats the purpose of using gates to protect illiquid investments.²⁵² However, the percentages could be kept lower if the investor was aware beforehand that the fund would employ a highly illiquid investment strategy. Investors could also negotiate to tie the use of a redemption gates to limited circumstances of liquidity. One way would be to limit the use of a gate until all the fund's liquid assets and a certain percentage of the fund's illiquid assets are used to satisfy the outstanding redemption requests. This would still allow the fund to mitigate the downside risk of a "fire-sale" on its assets, while not impairing its portfolio. This would also force the fund to pay out its short-term investments in the form of redemptions, instead of possibly holding back payments with the intention of profiting from fees.

Another restructuring option would be to limit the amount of time that a gate may be imposed. Most agreements do not limit the amount of time for which a gate can be used, but rather have blanket language providing for

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Exit Plan*, *supra* note 20.

²⁵¹ *Fistful of Dollars*, *supra* note 21.

²⁵² *Exit Plan*, *supra* note 20.

gate imposition on an “as needed” basis.²⁵³ Instead of allowing managers to hold their investments captive indefinitely, investors could negotiate a provision that ends the use of a redemption gate after six to eighteen months. Depending on the fund’s strategy, an adequate amount of time could be negotiated in order for the manager either to turn around performance or to create sufficient liquidity to meet investor redemption requests. This would prevent investors from facing a situation (which has been a reality for some recently) where their assets are held for two, three, or even four years without an opportunity to redeem.²⁵⁴

Also, investors could bargain to have more information rights triggered when gates are imposed. This would create a situation where investors can make better-informed decisions. Some may argue that more information may create an environment that is even more conducive to a “run on the fund.”²⁵⁵ However, in theory investors would act in their own best interest, limiting their redemption requests or possibly even staying in a fund.²⁵⁶ For example, an investor, after examining the fundamentals and strategy of a fund, may decide to stay invested even though it is experiencing liquidity issues because the investor may believe the long-term prospects of the fund are sound. Conversely, if a fund were suffering from mismanagement, poor strategy or divergence from previously disclosed strategy, investors would be better informed to force a liquidation. Regardless, more information could (and should) help investors act more rationally. One important aspect of all these solutions is the willingness of hedge-fund managers to bargain and negotiate with investors for more favorable redemption terms for investors. These kinds of concessions will assuage investors’ liquidity fears raised during the recent crisis and help investors trust that managers are acting in the fund’s best interest.

Lastly, the most contentious tool investors can use is litigation. The Delaware Chancery Court has made clear its disfavor for managers using gates with improper intentions.²⁵⁷ This Court recognizes the necessity for fund managers to carry out their fiduciary duties and it is apparently willing to punish managers if they fail to act in the best interest of investors.²⁵⁸ The most difficult aspect of this strategy for investors is proving the managers’ intent. Because investors can realize very tangible (and numerous) benefits when managers impose redemption gates, it will be difficult for investors to

²⁵³ *Fistful of Dollars*, *supra* note 21.

²⁵⁴ Williamson, *supra* note 126.

²⁵⁵ Chasan, *supra* note 159.

²⁵⁶ *Fistful of Dollars*, *supra* note 21.

²⁵⁷ *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. CIV.A.5502-CS, 2011 WL 3505355, at *2 (Del. Ch. Aug. 8, 2011).

²⁵⁸ *Id.*

show that managers were truly only self-serving in their actions.²⁵⁹ As such, it is in the best interest of investors to find fund managers that have compensation incentives closely tied with the performance of investor assets. Further, investors are more likely better served if managers invest a meaningful portion of their own assets in their funds. Because redemption gates are so harsh on the liquidity rights of investors and because the necessity of their use is difficult to disprove, investors should focus on the different options available to them before investing in a hedge fund and should demand the options that best protect their long-term investment goals.

²⁵⁹ See discussion of positive reasons for imposing redemption gates, *supra* Part IV.B.